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E.O. 12958: N/A
TAGS: ECON EFIN TRSY IN
SUBJECT: INDIAN PLANNING COMMISSION COMMITTEE ON FINANCIAL REFORMS PRESENTS ITS FINDINGS TO MUMBAI'S MARKET PLAYERS

¶1. Summary: In August 2007, the Planning Commission constituted a high-level Committee on Financial Sector Reforms (CFSR) to outline a comprehensive agenda for the evolution of the Indian financial sector. The Committee compiled its findings and suggestions in a draft report and put it up for discussion at a seminar held in Mumbai on June 12. Broadening financial products and markets, providing greater financial access to the masses, streamlining regulators, and encouraging financial literacy were some of the main recommendations of the Committee. The seminar was divided into five sessions starting with an overview session followed by detailed discussions on regulation, financial inclusion, banking and the macro economic framework. The Committee members had healthy dialogues with the discussants on each panel - comprising some of India's most prominent bankers and economists -- as well as answered the questions of the market participants present at the seminar. Overall, market participants praised the Committee for its report, though, predictably, some participants criticized it for going too far, and others, for not going far enough in recommending broad market reforms. End Summary.

¶2. On June 12, Raghuram Rajan, University of Chicago professor and Chairman of the CFSR introduced the draft report prepared by the Committee to the financial sector community, in an event hosted by the State Bank of India (SBI). The Committee was constituted by the Planning Commission in August 2007 with four terms of reference: to identify challenges in meeting the financial needs of the Indian economy and suggest sector reforms to deal with these challenges; to examine the performance of the financial sector and list the desirable changes; to identify changes needed in the regulatory infrastructure to allow the financial sector to play its role; and to recognize changes in other areas of the economy that could help the financial sector function more effectively.

¶3. Rajan told the audience that "India's financial sector is at a turning point," and had the potential to grow tremendously both domestically and internationally, if supported by appropriate policies. At the same time, he accepted that deficiencies -- such as inadequate financial inclusion -- could hinder growth and stability. In explaining the Committee's report, he said that it was designed with a five to ten year timeline in mind. It was intended to reflect the comprehensive views of the Committee's "stellar cast" including market practitioners, regulators, union representatives, politicians, academicians and international experts, and was not guided by a single viewpoint. The report was an outcome of discussions, dialogue and debates; he added that the feedback received in the seminar, if accepted, would be incorporated in the final report to be released on 30th September which would then be presented to the President of India.

Macro-economic framework

¶4. Beginning with the report's review of India's macro-economic framework, Rajan asked how India should adapt the current framework to the requirements of a dynamic open economy with a variety of players. First, he said "don't expect the Reserve Bank of India (RBI) to do magic." Under its current mandate, the RBI must juggle inflation, the exchange rate, and growth. He suggested that the RBI would function best by focusing solely on inflation instead of having multiple and, sometimes irreconcilable, mandates. An inflation-only focus would lead to more consistency in policy decisions which would automatically sustain growth. He stated that no central bank could prevent supply shocks; central banks tend to tackle the second and third round effects of inflation. Hence, a focus on inflation control would prevent "spiral effects." Secondly, Rajan urged the regulators to open up investment in rupee-denominated corporate and government bond markets to foreign investors.

¶5. Adding to Rajan's comments, Committee member Dr. Jayant Varma, a professor at Indian Institute of Management-Ahmedabad, criticized the Indian regulator's practice of banning products and markets, impeding participation from foreign investors, and imposing excess regulation. He added that markets "may look like casinos," but were not. Speculators provide liquidity and are needed in all markets, he said. He also strongly recommended that the RBI move towards full capital account liberalization as a longer term reform.

¶6. Reacting to the Committee's proposal, panel member Dr. D. M. Nachane, Director of Indira Gandhi Institute of Development Research (IGIDR), said he "violently disagreed" with the notion of opening up the capital account. He stated that the marginal benefit brought about by allowing capital account convertibility did not outweigh the risks that the economy would face. He pointed out that the report did not discuss strategies for moving towards capital account convertibility and added that he would discuss it in detail in his own research paper, to follow. Disagreeing with Varma, he said that markets are "casinos driven by `animal spirits'" and hence cannot be tamed, and that markets will always remain inefficient.

Financial Inclusion

¶7. As Rajan stated at the beginning of the seminar, financial inclusion was very important for the development of the financial sector. Out of total lending, only 12 percent is from formal sources like banks, while the remaining is from private money lenders, he said. The aim would be to eventually get these lenders into the formal channel. He emphasized that there were large gaps between the "intention" and "outcome" in providing access to finance. He also pointed out that credit was just one aspect; the financial environment needed products like savings, insurance, investment and pension to broaden the access to finance. For this, he proposed that both small and large financial institutions could tackle this problem. In his view, small, private banks have the advantage of being closer to the customer and rich with local knowledge which could be used to penetrate rural and urban communities. He suggested that the RBI enforce higher capital adequacy norms, more automation and transparency, and closer supervision, at least in the initial period to offset the high risk undertaken by the small banks. For the big banks, he advocated the liberal use of banking correspondents (BCs) to extend financial services.

¶8. To aid both the small and big banks, the Committee has suggested three major actions. The first proposed action is to offer priority sector loan certificates (PSLC) to entities that lend to eligible categories in the priority sector and also allow banks that undershoot their priority sector obligation to buy the PSLCs. (Note: Domestic and foreign banks operating in India are required to allocate a part of their net bank credit to priority sectors like agriculture, small scale industries, small business, housing, education, etc. End Note.) The second suggestion is to remove all interest rate caps for priority sector lending. Instead, he said, banks should be required to fully disclose the annual effective interest cost of a loan with the maximum and average interest rates charged. Thirdly, Rajan recommended improvements in credit infrastructure which would

entail expediting the process of creating a unique national ID number, sharing credit information more widely, and improving creditor rights by legislating a bankruptcy code.

¶9. Sir Thomas Harris, Vice Chairman, Standard Chartered Bank, criticized the restrictions on foreign banks, arguing that many foreign banks have tremendous experience and depth and could use their skills and knowledge to reach out into under banked communities. He added that the report did not address the issue of market access for foreign banks. He commented that investment in microfinance had more than tripled in other emerging countries, but India had been left behind. Dr. Nachiket Mor, President of the ICICI Foundation, pleaded that the Committee promote full banking services in rural areas rather than just one-product services. Those communities also need full-fledged services, he added. He acknowledged that creation of BCs was an interesting idea, as local entities would be more efficient than large banks. Also he preferred the use of the extant Permanent Account Number (PAN) system for investor identification rather than creating a new national ID, as recommended by the Committee. He suggested "dematerializing" currency to support the banking infrastructure. Promoting the use of e-banking facilities would cut down approximately 5-6 percent of the cost which was on account of currency handling and transportation, he added.

Leveling the Playing Field

¶10. Rajan noted that public sector banks (PSBs) are reasonably profitable, but are falling behind due to their lack of new market segments and products, talent, and the innumerable constraints on automation and risk taking. He asserted that through efforts to "protect" the PSBs, regulators are actually stunting their growth. In order to increase competition and efficiency, he recommended creating stronger boards for large PSBs giving more power to outside shareholders, or possibly a strategic investor. He urged the Indian government to reduce its oversight and suggested privatizing small underperforming PSBs to gain useful experience from the process. Allowing banks to set up branches and ATMs anywhere and being more liberal in allowing takeovers and mergers, especially for domestically incorporated subsidiaries of foreign banks, were the other reforms suggested by the Committee.

¶11. Deepak Parekh, Chairman, HDFC, agreed with Rajan that PSBs were constrained, especially in regards to capital. He noted that customers were demanding more from the financial sector and the need of the hour was "a small number of large banks and not a large number of small banks." He also recommended assigning timelines on the recommendation of the Committee, in hopes that this would force the government and regulators to implements its recommendations in a timely manner. O.P. Bhatt, Chairman of the State Bank of India (SBI) and also one of the Committee members, commented that the Indian government, as in case with most governments, often only undertook innovation in times of crisis, and now was the "perfect time" for the release of the report. He also pointed out that the report had found guidance from different reports but still managed to produce a unique product. On the issue of PSBs, he quoted a report by the credit rating agency Moody's indicating that PSBs were losing around 1 percent market share per annum on average for over 15 years to the private sector. Currently in terms of total assets, the PSBs have a 70 percent market share. "Hence it would take 70 years for them to wipe us away", he joked. He said that "earlier there was only one bank- the RBI -- and others were just outlets." In that time, the RBI made all decisions, and the banks were only administrators of RBI policies. Now, however, despite a fair amount of liberalization, PSBs still find it difficult to meet customer demands. PSBs were willing to change but the environment didn't support those changes. He was happy that the Committee had recognized this fact and hence was suggesting "evolution" and not a "revolution."

The Creation of more efficient and liquid markets

¶12. Rajan explained that the Committee listed numerous reforms

needed to support the enormous financing, investment and hedging needs of the "new" economy. The report recommends bringing all regulation under the Securities and Exchange Board of India (SEBI) and allowing the financial sector to experiment - cautiously - with new products and markets. To promote greater participation in domestic markets, the Committee wanted to see more and broader foreign participation and entry of transparent products for the poor.

¶13. K.V. Kamath, Managing Director and CEO of ICICI Bank and also a member of the Committee, remarked that every word was carefully weighed before putting it down in the draft. He also acknowledged that open markets were critical in ensuring that the financial sector kept pace with India's growth, especially when the nation was growing at 8-10 percent. Sanjay Nayar, CEO Citigroup India, however, expressed his skepticism that the recommendations of the report would be implemented. He highlighted the issue of access to funds, saying that only a AAA-rated project would be able to find long-term financing in India. It was very difficult for start-ups to find financial backing. In addition, the volatility in India's most liquid markets is higher in comparison to other developing countries. Consequently, he agreed with the Committee's recommendation to focus on the development of debt and derivatives market to hedge this volatility more efficiently.

A growth-friendly regulatory environment

¶14. Rajan highlighted the fact that India, so far, had not suffered from the recent financial crises. However in fear of being affected by crises, he denounced the excessive micromanagement of the economy by the regulator, and hoped that the regulator would not "govern the leaves instead of the forest". He appealed to create a transparent process of evaluating performance -- rather than adherence to rules -- and rewrite financial sector regulation. He also laid down guidelines to tackle regulatory gaps and co-ordination. He proposed setting up a Financial Sector Oversight Agency (FSOA) whose role would be purely to monitor and supervise the functioning of large, systemically important financial conglomerates, address inter-regulatory conflicts and look out for the build-up of systemic risks. He also promoted the development of the Office of Financial Ombudsman to spread literacy and counseling among the masses and a Financial Development Council to be headed by the Finance Minister to implement structural reforms in the financial sector.

¶15. With regards to issues of micromanagement, P.K. Nagpal, Executive Director, SEBI, did not agree with the Rajan report. He insisted on amending the paragraph on micromanagement in the report. He maintained that SEBI followed both principle and rule based regulation with investor protection, development and protection of security markets being the main objectives. He added that they were setting up a National Institute of Security Markets to promote investor education. O.P. Bhatt stated that the report does not recommend going so far as to prompt a crisis. For example, he said that India has only about 20,000 ATMs, but the country needs close to 100,000, the PSBs were starved of capital, and Indian banks lacked sound risk management practices. Deepak Parekh added that in any financial system, there were bound to be bubbles. While the Indian financial system was sound, an efficient regulator had to anticipate the bubbles and take appropriate steps to avoid a crisis situation. Rajan clarified that the report was a pathway to take us forward. It was not a map taking us where other financial markets were.

¶16. Comment. The Rajan report, instead of focusing on a few large and controversial steps, as some reports before it have, lays down numerous small steps that will collectively help to develop the next generation of reforms for the Indian financial sector. The report strives to build a bridge between the capacities-capabilities of the financial sector and needs of the real economy. It recommends including more Indians to foster growth and building up financial stability by bringing the regulator under the scanner. The report looks at the multiplier effect of the developments of the Indian financial environment

in contributing to the economic growth rate. Overall, these are sound recommendations, though many feel they are not enough. However, since the decision to move forward with banking and financial sector reforms is largely political, rather than economic, in nature, small steps may be the best approach for the current environment. End Comment.

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